

**LEGISLATIVE SERVICES AGENCY
OFFICE OF FISCAL AND MANAGEMENT ANALYSIS**

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FISCAL IMPACT STATEMENT

LS 8139

BILL NUMBER: HB 1899

DATE PREPARED: Apr 27, 1999

BILL AMENDED: Mar 25, 1999

SUBJECT: Insurance Premiums Tax rate reduction.

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FUNDS AFFECTED: X GENERAL
DEDICATED
FEDERAL

IMPACT: State

Summary of Legislation: (Amended) This bill reduces the insurance premium tax from 2% to 1.3% over a five year phase-in period.

Effective Date: (Amended) January 1, 2000.

Explanation of State Expenditures: (Revised) The Department of Revenue and the Department of Insurance will incur some administrative expenses associated with changing tax forms, instructions, and computer programming.

Explanation of State Revenues: (Revised) The Insurance Premium Tax is assessed on gross premiums received on policies covering risks in the state of Indiana. The tax base is comprised of premiums written or renewed in the past year minus deductions of reinsurance premiums, dividends paid to resident insureds, and premiums returned. The tax rate is currently 2.0% of these net premiums. The tax is paid by all insurance companies doing business in Indiana, however, companies domiciled in Indiana may elect to pay the Corporate Gross Income Tax in lieu of the Premium Tax (domestic firms also must pay the Supplemental Net Income Tax, or SNIT). Revenue from the Premium Tax is deposited in the state General Fund.

Reducing the Premium Tax rate could affect revenues from the Insurance Premium Tax, Gross Income Tax, and SNIT as follows:

Insurance Premium Tax: A reduction in the Insurance Premium Tax rate may affect domestic insurance companies differently than out-of-state entities:

(1) *Effect on domestic companies:* Decreasing the Insurance Premium Tax rate by 35% would not simply reduce the amount of tax due on premiums written in Indiana by the same proportion. This is partly because domestic companies may elect to pay the Gross Income Tax in lieu of the Premium Tax. In fact, of

the more than 130 insurance companies domiciled in Indiana, only 39 currently elect to pay the Insurance Premium Tax. Only about \$4,556,000 in premium taxes were paid by Indiana domiciled insurance companies in 1997. If the Premium Tax rate is lowered, more companies may find it advantageous to pay the Premium Tax, simultaneously reducing Gross Income Tax revenue.

(2) *Effect on insurance companies not domiciled in Indiana:* The impact on out-of-state insurance companies varies with each state of domicile. This is due to Indiana's retaliatory tax provision, which provides that premiums written in Indiana by a company not domiciled in Indiana are taxed at either Indiana's rate or the rate in that company's home state, whichever is higher. The varying effects of the retaliatory provision are outlined in the following paragraphs:

(a) *Rates of 2.0% and above:* Premium Tax revenue collected from companies domiciled in states with a rate of 2.0% or higher would not change, no matter how low Indiana's rate was set. Because of the retaliatory provision, Indiana would collect at the higher of the two rates, which would still be at least 2.0%.

(b) *Rates between 2.0% and 1.3%:* Under this bill, Indiana will lose some revenue from companies in states where the Premium Tax rate is below 2.0% but above 1.3%. Connecticut, for example, has a rate of 1.75%. Under current law, the tax on premiums written by Connecticut companies in Indiana would be assessed at 2.0%. After a change in Indiana's rate to 1.3%, taxes on Connecticut premiums would be collected at 1.75%, the higher of the two rates. The retaliatory provision mitigates the potential loss with companies from states with premium tax rates between 2.0% and 1.3%.

(c) *Rates below 1.3%:* For companies domiciled in states with rates below 1.3%, the effect would be to reduce taxes paid in Indiana by 35%. The highest rate that would be applied would now be 1.3%, not 2.0%.

Although the retaliatory provision mitigates the potential loss, Premium Tax revenue from out-of-state companies would likely decrease whenever the rate is lowered. The net effect depends greatly on the number of domestic companies that switch to pay the Premium Tax rather than the Gross Income Tax. The impact of the proposed rate change on Insurance Premium Tax revenue was estimated using a model that included retaliatory tax effects. Three important assumptions made in this analysis are:

- Based on recently proposed or enacted legislation, changes and phase-downs in premium tax rates of neighboring states were incorporated in the model. Rates were lowered to 1.4% in Ohio, 1.5% in Kentucky; and 1.5% in Illinois (other various reductions in Alabama, Colorado, Tennessee, and Washington DC were also applied). All other states were assumed to maintain the same rates imposed in 1997.
- The majority of Indiana domestic insurance companies do not pay the Insurance Premium Tax. If the rate was lowered, more companies may elect to pay this tax in lieu of the Gross Income Tax. It is not known if a 1.3% rate would be sufficient for all firms to make this transition. However, it is believed that most companies would continue to pay the Gross Income Tax despite the decrease in the Premium Tax rate. For the purposes of this analysis, it was assumed that no companies would switch from one tax to the other.
- After considering past premium tax collections and their cyclical nature, premiums written in

Indiana (life, property, and casualty premiums only) were estimated to grow by 2.5% annually.

Insurance Premium Tax: Based on the assumptions stated above, the following table illustrates the impact of the phase-down of the Insurance Premium Tax. The revenue loss reported below reflects the reduction in revenue due to the reduced rate after estimating growth in premium revenue collections at the current 2% rate.

Fiscal Year	Premium Tax Rate	Revenue Impact
2000	1.9%	(\$4,500,000)
2001	1.8%	(\$9,200,000)
2002	1.7%	(\$13,700,000)
2003	1.5%	(\$22,200,000)
2004	1.3%	(\$26,000,000)

In 2004, the phased-down rate would result in an estimated loss in Premium Tax revenue of about \$26 M. Even if the rate remains at 1.3% after 2004, the negative impact may gradually increase if premiums continue to grow.

If the same domestic companies currently paying the Premium Tax are taxed at 1.3% in 2004, these firms would see their Indiana Premium Tax liability reduced by about \$2 M due to the rate reduction. The remaining \$24 M represents both tax savings for out-of-state insurance companies and a loss of retaliatory tax revenue for Indiana. It should be noted that reducing the Premium Tax rate will reduce retaliatory payments made by domestic companies to other states, regardless of which tax these firms currently elect to pay within Indiana.

As stated above, this model includes proposed or enacted changes in other states. Because some states that previously had premium tax rates (or effective premium tax rates) above 2.0% and are instituting reductions, Indiana will lose some revenue unless the present Premium Tax rate was increased. If Indiana's rate remains at 2.0%, the already proposed or enacted reductions in Alabama, Colorado, Louisiana, Ohio, and Washington DC will generate an annual loss of more than \$3 M in retaliatory tax revenues to Indiana beginning in 1999. To account for this effect, this amount has already been subtracted from the impacts shown in the table above.

Gross Income Tax: The Gross Income Tax is normally assessed on the total gross receipts of a corporation's transactions in Indiana. However, not all of the gross receipts of an insurance company are taxed under the Gross Income Tax. The tax rate is 1.2%, and revenue from this tax is deposited into the state General Fund.

Only 39 of the insurance companies domiciled in Indiana currently elect to pay the Insurance Premium Tax. The remaining companies paid a total of approximately \$30 M in Gross Income taxes in 1997. Because the projections in the table above assume that these companies will continue to pay the Gross Income Tax even after the Premium Tax changes, Gross Income Tax revenue would be unaffected. However, as the premium tax is reduced, more companies may find it advantageous to pay the Premium Tax. If all companies switched to the Premium Tax, annual Gross Income Tax revenue would decrease by at least \$30 M (based on 1997 payments). Some of the potential loss in Gross Income Tax revenue

would be offset by a corresponding increase in Premium Tax revenue.

Supplemental Net Income Tax: Supplemental Net Income Tax liability is specially calculated for domestic insurance companies. The tax base is the federal taxable income of the company adjusted by:

- (Step 1) Multiplying the federal taxable income by the ratio of premiums tax receipts from policies insuring persons or property in Indiana to total premiums receipts; and
- (Step 2) subtracting the company's Gross Income Tax liability or the gross premiums tax liability, depending on which one the company has elected to pay.

The adjusted tax base as calculated above would then be multiplied by the SNIT rate of 4.5% to determine tax liability. SNIT revenue is deposited in the state General Fund.

If an insurance company switched from paying the Premium Tax or Gross Income Tax to the other because its taxes burden would be less, the amount subtracted in Step 2 would be smaller, resulting in greater SNIT liability. The DOR estimates that between \$5 M and \$8 M in SNIT is paid annually by domestic life and property and casualty insurance companies. This amount appears to vary annually due to the effects of filing consolidated returns and tax credits claimed by these companies.

If Indiana domiciled insurance companies continue to pay the same tax (either the Gross Income Tax or the Insurance Premium Tax) as they elected to pay in 1997, a reduction in the Premium Tax rate to 1.3% would generate \$2 M in tax savings for the Premium Tax payers (as mentioned above) in 2004 when the reduction is fully phased-in. These companies would not be able to deduct this net gain from their adjusted tax base (see Step 2 above), resulting in an annual state increase of \$90,000 in SNIT revenue (\$2 M x 4.5%). Gross Income Tax payers' SNIT liability would be unaffected under this scenario.

NET IMPACT: The table below summarizes the estimated net impact in 2004 for life, property, and casualty insurance premiums upon full implementation of the Insurance Premium Tax rate reduction from 2.0% to 1.3%:

Impact in FY 2004 (fully phased-in reduction)	Revenue Impact
Premium Tax impact	(\$26,000,000)
Gross Income Tax impact	\$0
SNIT impact	\$90,000
NET IMPACT	\$25,910,000

Based on the previously stated assumptions, the projected impact of this bill would be a \$25.9 M decrease in state General Fund revenues by the final phase-out year. It is important to note that reducing the Premium Tax will reduce the cost of doing business in other states for Indiana's domestic insurance companies. The total benefit to these companies as a result of this reduction is not currently known, but is expected to be significant. If these companies remain and prosper in Indiana or if new business is

attracted to the state, corporate and personal income tax revenues could increase.

Explanation of Local Expenditures:

Explanation of Local Revenues: (Revised) If a lower Premium Tax rate helps Indiana's domestic insurance companies expand, corporate and personal income tax collections could be increased, benefitting counties with local option income taxes.

If an insurance company relocated outside the state because of lower Premium Tax rates in other states relative to Indiana's 2.0% rate, local property tax burdens could be shifted to other taxpayers.

State Agencies Affected: Department of Revenue, Department of Insurance.

Local Agencies Affected:

Information Sources: Department of Revenue; Department of Insurance.